Lakshman Achuthan: A Soft Landing Still Looks Like A Dream

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Erik: Joining me now is ECRI co-founder Lakshman Achuthan. Lak prepared a slide deck to accompany this week's interview. Registered users will find the download link in your research roundup email. If you don't have a research roundup email, it means you haven't registered yet at macrovoices.com. Just go to our homepage macrovoices.com, click the red button above Lak's picture that says looking for the downloads. Lak, it's great to get you back on the show. I'm really looking forward to this because boy, last time we spoke, the long awaited recession was still on deck. We were still expecting it, you thought a hard landing was much more likely, as did I. We saw at that point the stock market was really turning down. Well guess what? It's turned back up again, which a lot of people didn't expect back up above the 200 day moving average. It's kind of causing some people to question whether or not that hard landing is still on deck, is it?

Lakshman: You know I think it is. Thanks for having me back. But I think it still is on deck. We spoke in August. You're absolutely right. We thought a hard landing is more likely. We've been continuing to work through all this post-COVID and kind of structural crosscurrents that were in the mix that we were talking about back then. And we continue to rely on our cyclical framework to kind of see the path forward, including: is there a real acceleration? Is there a soft landing taking shape? And when we look at the cyclical indicators, it doesn't seem to be in sight, yet. So the market is hopeful, as you said, it's been working up different narratives of kind of threading the needle with inflation coming down, yet growth not coming down that much. And that's a hard needle to thread. I brought a whole bunch of stuff for us to talk about today, to kind of help listeners and all of us see what we're looking at in terms of these cyclical indicators. And at the end of the day, I hope there's some more clarity on the direction of where growth and inflation are going, both in the US and abroad.

Erik: Lak, let's dive into the slide deck starting on page five. Where is this growth that we're talking about?

Lakshman: Yeah, I mean, there was a lot of excitement around the GDP number coming out, like I think it was 4.9 was the initial print. And so therefore, the conclusion immediately was there, there's no recession, we dodged it. And slide five, I think presents a more comprehensive picture than any one statistic like GDP. It's the US coincident index growth rate. You can see the chart shows a very clear slowdown, and no acceleration. And this measure is important because by focusing on multiple measures of economic activity. We avoid the pitfalls of relying solely on a single metric, like say GDP, although GDP is in that line. And there's a well-worn common belief that it's two consecutive quarters of negative GDP growth that define a recession. And you know, that can be the case. But it's not a necessary nor sufficient way of thinking about what a recession is. It's really a vicious cycle of falling output, which is GDP and industrial production, or employment or income and sales. And all of those measures are included in the line shown on the chart. I think it's slide five of the deck.

Now, GDP is a very important metric, as I said, it's in that line, but it doesn't give a full picture of how an economy is doing on a cyclical basis. Listeners may recall that last year, it actually was negative, I think, for two quarters in a row in Q1 and Q2, but there wasn't a recession. There was no recession there. And of course, back in the Great Recession '07-'09. You didn't see a negative GDP print until the end of July, about seven months inside the recession. So we think and you know, I've been doing this for longer than I care to admit and looking back at previous work of my mentors, that you need to really be looking at a coincident index. That includes output, employment income, and sales to know which way the wind is blowing on the economy. That's our target. And so the key takeaway from this slide here is that the revival and growth that everyone is kind of banking on it's not here, the slowdown continues. And as I said, I'm kind of thinking in leaning towards it slowing further perhaps going negative, as opposed to re-accelerating in the near term.

Erik: Lak, you are Mr. Cycles through and through, and obviously very good at looking for and recognizing patterns. Is there a pattern or signal in the very fact that your own indicators have been, you know, in anticipating this recession for longer than it usually takes? It's been quite a while now. Is there a precedent where we look back to the past five times your indicators were indicating a recession for more than x amount of time? You know, what happened next was… fill in the blank?

Lakshman: That's a great question. And look, my real time experience begins where I was just, you know, full time looking at cycles begins with the 1990-91 recession. And before that, I've studied but I didn't experience it firsthand. Now, what you're talking about is okay, the leading indicators turn one way or another and how long does it take until it shows up in the coincident data? One thing is the coincident data gets revised. So when you're looking at that data today, it's not the way it was in real time when those turns happened decades ago. But the answer is, there are some times when you get really long leads. You know you can have leads that are over a year easily, at turning points, especially on the approach to a downturn. The leads on upturns tend to be shorter. It's just the nature of the beast. And so, you know, there were recessions. I mentioned earlier in the Great Recession, how you didn't see something like GDP go negative until seven or so eight months into the recession. You didn't see jobs go negative until about the same lag, like seven or eight months into the '73-'75 recession. I mean, totally different circumstances. But does this framework have long leads in it? Yeah, that can happen. So we can have an average lead of a couple of quarters, but you can have a long lead of more than a year. I think in this instance, why are we seeing such a long period of kind of slowing, but no outright recession? I mean, as I mentioned, you also had two negative quarters of GDP last year. What's going on? It really is this tug of war, we're really stuck in the backwash of COVID. There's so many extreme things that occurred. One is a huge gutting of labor supply, for various reasons, which we can get into, I'm happy to. And the other is a massive policy response to COVID, which introduced all kinds of imbalances, in particular in the labor market. And so I think the main reason that the coincident index hasn't gone negative, it kind of slows and then is running at a reasonably weak level is because of the jobs component where there has been a great deal of labor hoarding, of limited supply of workers. If you go to the next slide, and look on slide six, you could see the innards of what's going on there. I mean, obviously, jobs growth has continued, and it's part of the narrative around soft landing right but...

Erik: Tell me a little bit more about page six, why education and health specifically? You're showing nonfarm and you're showing nonfarm minus education and health. Why those particular sectors?

Lakshman: You've got the view that, hey, the blanket statement, jobs are great, the consumers hot, we're good to go, we're going to see a reacceleration and so on and so forth and you know, that story. But when you look inside of what's going on in the jobs market, you see a classic recessionary performance of education and health jobs versus all the other jobs. And education and health are what we would call non-discretionary kind of things that you need, right? You don't… even though some kids would maybe not like to go to school, they have to go to school, right? And if you want to develop a good career, you probably are going to get some training of some sort. And healthcare, it's not really discretionary. For the most part, if you're sick or hurt, you need healthcare. And so, you see that the jobs growth going into recession, you get this gap that sets up where the non-discretionary jobs growth holds up. But the discretionary jobs growth, everything else starts to deteriorate noticeably and this chart shows how that nonfarm growth minus education and health is just coming down very, very fast. If you look at past recessions that we show on this chart, back to the early 90s, that gap is a telltale sign of cyclical recessionary weakness. In the jobs market. What's different is that we lost several million people out of the jobs market, either from less legal immigration before COVID, and then people leaving the workforce or not returning to the workforce post-COVID.

And you throw on top of that, the big fiscal push on demand, and you get a very, very tight labor market, where we have labor hoarding, a very, very reticent set of managers in terms of letting people go, and you are starting to see managers, you know, they've been making some moves over the summer. For example, temporary jobs have been negative growth, right, for months now. You've seen hours worked coming down pretty quickly. You see more and more part timers versus full timers, in terms of jobs growth, these are all the levers that managers can pull, when they're concerned about weakening demand growth. And at the same time, remembering how hard it was to hire people not so long ago, when business was booming. And as a result, we have the situation where, so the hiring is slowing quite quickly, the firing en masse, maybe there were a few companies that took a run at it last year, some bigger ones, and then there really hasn't been a move to shed jobs just yet. You see the jobless claims still relatively low, right? They're bouncing around all these low levels, every once in a while. They look like they're going to ramp up, and then they ease back. And I think that's this issue of kind of labor hoarding, I remember how hard it was to hire people. And I'm hearing all about this soft landing, and how you know, the Fed is going to stick the landing here. So I'm very hesitant to let people go. I think that's the world we live in right now. This tug of war between cyclical weakness, and noncyclical supply and maybe even in some cases, demand issues where the federal government really stepped in like nonresidential construction where if, you know, there's some factories being built and whatnot that require people.

Erik: Let's move on to page seven where you say inflation to stay sticky, you know, the headline, very much matches my own view of, I'm expecting a new secular inflation has begun. But as I look at the CPI inflation on your chart, I mean, it kind of looks like it's headed down, doesn't it?

Lakshman: There's a lot of things at play, there's the cyclical, noncyclical stuff on jobs. And the noncyclical stuff contributes to the tightness of the labor market, which can be inflationary, of course. And then you've got your structural or secular stuff, which I think you're alluding to, where you have to be very careful, if you're getting higher lows in the inflation cycle. Inflation is going to cycle, that's what it does. But from a structural point of view, you want to be very careful that you're not getting higher lows in those cycles, because that can speak to a bigger problem. And I think that's kind of where you're coming from. On this slide on page seven, first, I just want to make a distinction for listeners. If you think about it, a lot of analysis on inflation, pretty much amounts, and it's not a dig at it, it's just the nature of econometric modelling. It amounts to extrapolating recent trends in backward looking price measures. And so the backward looking price measures would be the lower lines there, on this chart of the target actual inflation. So you extrapolate it and you're like it's going down, or at least you hope. In contrast, we're watching our forward looking future inflation gauges, and they've been very prescient. I think these are a little more esoteric because a lot of people just think about growth and inflation in the same breath and we don't. We really recognize them and treat them as completely separate cycles. And the future inflation gauge was very good in catching the strong inflation upturn in 2020, the downturn in 2022. And the point today is that our forward looking indicators of inflation had been pretty much flat this year. Okay, that should put a damper on hopes of a faster decline in inflation. So if underlying inflation pressures, which is what we're trying to capture with that forward looking indicator, that means if they're not falling fast, and they're not, then actual inflation is liable to be, you know, “stickier for longer.” And this is in conflict with kind of the hope that there's going to be all this progress towards the Feds goals on inflation, in fairly short order. And here, there's a future inflation gauge. I think here I'm showing the alternative future inflation gauge, it's the same concept, but it's a different composition of the actual metric. And we use it to kind of check and double check the directional calls. And so these indicators I'm showing you here, they really nailed the earlier turning point calls, and they're saying not so fast right now. And that's at odds I think with some of the expectations on what's happening with the inflation cycle.

Erik: Lak, I hear you on the concept of lower lows, would indicate a changing trend to, maybe to the upside, but at the same time, I and a lot of other people have kind of staked our view on the idea that look, the Feds never going to be able to get us back down to 2%, their target. Now

2%, let's say they got down to 1.9%. On the one hand, that would be a higher low, if we bottomed at 1.9%. It will be a higher low than the previous low, which is like zero. But I would still have to throw in the towel on my view and say, wait a minute, if they got us back down to 1.9, which is below their target, okay, that's something I didn't think they could do. My view was proven wrong at that point. So how would you see that? Let's say we did get to just below 2%. That's where we bottomed, was between 1.7 and 2.0. Does that mean that we're still looking at a new potentially structural uptrend or does it mean that that view has been proven wrong?

Lakshman: I think the former. I can see a world from a cyclical vantage point, okay, where you go to 1.9, to use the scenario you were just saying, but we're still in a structurally inflationary year, a new era. And let me explain how we get there. First off, I'm not sure exactly what the expectations are but if the expectations are that they're going to get down to 2.0, and 1.9 and 2 are basically the same thing. If the expectation is that we're going to get there sometime next year or whenever, the come down in demand that would be associated with that is larger than what's expected. Typically, inflation cycles will bottom, will trough and reach their lowest readings after the recession is over, not in the recession. So there's some time lags that I think need to be appreciated. You typically have the real come down in prices, after the recession in the earlier stages of the sometime in the recovery actually. It doesn't even have to be early in the recovery.

And the second thing is that those are cyclical highs and lows in the 70s, which is our last inflationary era. The lows were under 3% and the highs were over 13% in the cycle of inflation, and it averaged 7% for that rough decade. So yeah, sure, if we have a nasty recession, and I don't know that, that a hard landing would necessarily be severe or mild at this point. That's hard to know. But if it was a very sharp one, you could have prices go down and inflation go down to 2% and say, oh we rang the bell, we hit our target. But that might just be a cycle low in an era of higher inflation because productivity is very weak, right? You're doing a lot of onshoring, which is inflationary. We're spending a lot of money on defense, which is inflationary. We have a whole bunch of other deficit issues. And we're spending quite a bit which is inflationary. These are all inflationary things right? In the indicators, the future inflation gauge, these forward looking indicators which are measuring underlying inflationary pressures, implicitly are picking all that up. That's the key. They're picking up those underlying drivers of inflation, and then they're objectively adding them up and giving us a directional call. And this is what it is currently, it's those underlying measures, while they have not turned up on a cyclical basis, they've stopped falling. And so, getting to lower and lower readings in inflation may take a little longer than the market is betting on right now.

Erik: Lak, on the alternative future inflation gauge on page seven, how long is the typical lead? In other words, the red line here is the leading indicator, and the coincident indicator is the black and grey lines. What's the lead time typically?

Lakshman: These are, I'd say, on the order of three quarters, the alternative thing is maybe a little on the longer lead side than that, on average, over all the inflation cycles. I think here we're just looking at a couple of them. But this goes back, at least to WWII and in some cases, a little earlier. So, and all those inflation cycles, the average lead is about three quarters, but I wouldn't do a lot of precision on that. I wouldn't line it up and bet the store on it. But I think the way to use these indicators is to say, you know, what's the prevailing view? And is the trend, the direction that this is suggesting in agreement or is it divergent? And right now, if I put words in the market's mouth right, and I say ah you're expecting them to kind of get to their targets sooner rather than later sometime next year? I'd say not so fast, based on the lead times here.

Erik: We move on to page eight, instead of the future inflation gauge, you're back to the Feds official measure. But this time, we're looking at the PCE deflator. What's the reason for that change and what is this chart telling us?

Lakshman: Yeah so this is, you know, did things get sticky. And that little bit of a, I don't know what you want to call it, a golf club, a hockey stick at the end there, where it is kind of going down according to script, and then go sideways, is consistent with what the forward looking data said. And I think this is where the Fed is kind of dialed in. They're looking for trends in measures like this. And what they need to consider is, wait a minute, did that bottom there or is it going to keep going down? And they want to get that one right. They don't want to make a mistake and prejudge that. So, if they assume that that's going to continue going down to very benign readings, and it doesn't, now they've got higher lows in the inflation cycle. And that's probably one of their nightmares, right? I'm sure they have several nightmares, but I bet that's one of them. So they're going to want to avoid that. Powell has said a lot of things, he says, you know, he's getting to be a little bit like Greenspan, where he says a little bit of something for everybody. But I do believe that he does want to try and get it down towards some 2% target. And at the same time, he's aware of the risk of over tightening. But being in such a delicate spot with those forward looking data going sideways, think that they know that they've got a problem. And on balance, when you have the unemployment rate very low, when you have job growth still, they're there, the odds are, they're going to stay restrictive longer than maybe what is hoped in the soft landing kind of narrative that is out there. Mind you, you go back to the jobs chart that we had earlier, and you have education and health and these kinds of things where there's still jobs growth, and everything else that is more discretionary is going down. When you look at embedded kind of inflation, one of the things Powell, from time to time will talk about is wage growth, which is necessary when you have that much inflation as we had. And it's been stuck around five and a quarter percent for the last several months. You know, it did fall over 1% in the previous year. So I went from a six something handle to a five something handle. But it's hard to say that's under control from a Fed policy of position of trying to have low and stable inflation. I think that's a concern that they're going to keep watching. I don’t think they're ready to say mission accomplished just yet.

Erik: Moving on to page nine, you're comparing the 21-Country long leading index, which I believe is an equity developed index against world trade volume. Tell us a little bit more about that 21-Country long leading index and what this chart is telling us?

Lakshman: Yeah I mean, we've been talking about what's going on at home, so directionally everything is to the downside, still the reacceleration is not clear. And the Fed has some challenges. And when we look abroad, it's not like we're going to get bailed out by some other economy, kind of pulling us along. And that's the point of this chart, the 21-Country long leading indexes is a leading indicator of growth in those 21 countries. And that's all the major economies, all the big ones plus all the big emerging markets. India, China, Russia, South Africa, all these emerging markets, and Brazil. And as it happens, that long leading index is also a really good predictor of turning points in world trade. I think the only exception where it wasn't spot on was just pre-COVID when the Trump tariffs went on really fast. Those kind of came on and they hit trade for a second pretty quickly. But in terms of kind of the cyclical drivers of trade this thing nails it. And in September of ‘22, you had a nice decline in trade volumes. I mean, it's clear on the chart below. That's what I mean by nice. And it echoes the previous downturn that we saw in this leading index. And that trend of the declining long leading index is predominantly downward. It's right now, it’s near the low point that we saw back in July, and that's nearly a two year low. And mind you, these aren't growth rates, these are levels of activity. So, that's kind of serious. That's the amount of activity. And so here, there's cyclical weakness ahead, there's going to be an ongoing decrease in world trade, which is kind of a big deal. I think it's a big backdrop there. And those kind of sustained downturns in global trade volume, they're typically aligned with broader declines in overall global activity. So, I think that backdrop within which the US is doing relatively really well, is a pretty tough backdrop. And that's an important thing to keep in mind. We're just not getting bailed out by something abroad right now.

Erik: Let's talk a little bit more about China in specific, because a lot of people had one set of expectations about what was going to happen in terms of China's recovery. Seems like the data is not really showing that but you know, forgive me for sounding a little conspiratorial here, but I'm also getting a lot more skeptical of Chinese data lately. And one of the reasons for that is almost everybody on the oil market got caught wrong footed, really expecting that there was going to be super tight oil markets in Q3 and Q4. It started to happen in Q3 but it didn't really materialize, like everybody thought, and what really hit me was, even after everybody was proven wrong, all the big analysts scratch their head and said yeah, we still can't figure it out, because our data is still telling us that what's happening is not what's happening. And the only explanation for that is a whole bunch of black market oil, you know, oil that has bypassed sanctions, has made its way into supply. So the official supply numbers are smaller than the real world supply numbers. It makes me wonder okay what else in terms of Chinese data if China is not as friendly with the United States as it used to be might not be accurate?

Lakshman: Well, let's just stipulate that the data is, to put a nice word on it, funky. Okay I agree, and we don't hang our hat on any one of those pieces of data, the cyclical approach that we're describing, and showing here is very forgiving for bad data. Because, to the extent something nefarious is going on, there's probably not an awareness of moving inflection points around, there's probably, you know, you might flatter a number here or there to try to make the level look a little better. But the inflection points we found over many, many decades over many, many different countries, a lot of emerging markets or whatever markets, and those are pretty darn stable. So we think our directional calls on things like China and other emerging markets are really good. And while we saw the mechanistic recovery in China, post opening, we had a very lonely call where we said no, it's not off to the races in China, because they've got cyclically, no recovery in the forward indicators, there's something mechanistic happening. But there's not a lot of data there. And in particular, this was showing up in the industrial leading indicators, a leading indicator for Chinese industrial production growth, which is part of a larger framework of global industrial growth leading indicators, which have been pretty much as bad as they could be earlier on, in conjunction with one of the most pervasive global tightenings by central banks that we've ever seen, post COVID. So the simple answer is that the cyclical decline in global industrial growth, including inside of China, the decline or the weakness in Chinese industrial growth, was correctly picked up by leading indicators like the ones I'm describing to you. And I think the narrative got ahead of itself, the reopening, some stimulus, we're off to the races because that was the pattern that you might have seen in a handful of years earlier. I also want to point out, there was another time that came to mind when you said that, when you described the false start from China this year, was in the mid-teens in the United States, we had a solid industrial sector downturn which was part of a global industrial downturn. And I remember years later, I saw this big, you know, in depth research piece in The New York Times about, oh this cycle that nobody ever saw, and it was plain as day in the cyclical leading indicators but it did not show up in some of the kinds of analyst reports that you might see out of Wall Street, they didn't see it coming.

Erik: Lak, final question! It seems to me that we are in what I feel is a new era of geopolitics. It seems that the Ukraine situation has escalated initially to the point where the US made it clear that one of their goals was to weaken Russia militarily. We do now see some de-escalation of the Russia-Ukraine conflict. I think that's only because Ukraine has pretty much run out of soldiers to fight with. But we're also seeing, of course, the sudden escalation of the Israel conflict and a lot of people are fearing a US-China conflict. How do we reconcile or how should we be thinking about the cycles work that you do, which is primarily focused on economic cycles with this separate geopolitical trend towards what I think is going to be more conflict in the world in coming years. Is it already reflected in your cycles work or do we need to consider that as a separate cycle or how should we be thinking about it?

Lakshman: Great question. Look, good leading indicators, and I think we have some very good ones, will implicitly pick up the evolution of those issues that you raised. And to the extent they're going to push the cycle in one direction or another, they will manifest they will show you that. Look, all this conflict, of course, is good for defense companies so they've got a bid. But it also introduces a whole bunch of uncertainty for decision makers, which sometimes may not be a bad thing, I mean, near term that can contribute to a cyclical slowdown, and probably is. But longer term, it may merit some more considered decisions, you know, a little more kicking of the tires when you're doing things, there's going to be obviously some onshoring and things like that going on. If you're going to invest and build, you're going to think it through a bit more. I think also, with the inflation, the cost of capital going up, you're also going to challenge your business models a bit more than you would before. Earlier on, I'm happy to carry a ton of inventory because it doesn't cost me anything to finance it. Now, do I want to tie up my money doing that? These are good questions, probably. So I think that things are changing. Obviously, I think there may be a silver lining here in some of the more considered decision making longer term. However, short term, business as usual is certainly a challenge. Those business plans that worked in the lower inflation, in all-the-skies-are-blue environment of several years ago, won't fly today. Recessions, if that's what we end up with here, look, recessions are not the end of the world. They're not Armageddon. They're part and parcel of a free market oriented economy, there can be collateral damage and it hurts to be the vulnerable people that get hurt by it. But they're cathartic for the overall system, in that they kind of weed out the less productive, more vulnerable, maybe unwarranted activities and focus the economy on more productive and profitable ventures. That's what recessions do. It's an important part of a free market.

Erik: Lak, I can't thank you enough for a terrific interview. But before I let you go, please tell us a little bit more about what you do at ECRI, which is primarily an institutional research firm. We have quite a few institutional listeners. What services are on offer and how can they find out more about what you do?

Lakshman: You know, I'm not a natural at this but we want to partner and work with institutions that are trying to figure out how to systematically lean on the right side of these cyclical moves. What I've seen, as I mentioned, I've been doing this since 1990 with companies and investors, is that if you get on the right side of these cyclical moves, might I even say tactical moves, right? That you start to outperform your peers and you have strategic opportunities. And that's what we're really providing and we're at businesscycle.com and you can find us there or on LinkedIn.

Erik: And those contact details are also on the last page of the slide deck. Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com.